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UNCLAS SECTION 01 OF 04 TAIPEI 003142

SIPDIS

STATE PLEASE PASS AIT/W AND USTR

STATE FOR EAP/RSP/TC, EAP/EP AND EB/IFD/OIA

USTR FOR SCOTT KI

USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER  
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT

TREASURY FOR OASIA/ZELIKOW AND WISNER

TREASURY PLEASE PASS TO OCC/AMCMAHON

TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF  
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: N/A

TAGS: [EINV](#) [EFIN](#) [ECON](#) [TW](#)

SUBJECT: Taiwan's Semiannual BOP Surplus Soaring

SUMMARY

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[1](#)1. Taiwan's balance of payments (BOP) surplus in the first half of 2004 doubled from a year ago to US\$24 billion, increasing Taiwan's foreign exchange (FOREX) reserves to US\$234.6 billion. While this sharp increase is unusual, it is not likely to continue, and does not presage financial problems. The sharp increase is mainly due to massive bank borrowing to meet local corporate demand for foreign currency loans. The loans are being used primarily to purchase production inputs for exports, and local banks own huge foreign assets roughly equal to the amounts borrowed. Taiwan's current account (C/A) surplus almost matched capital outflows of direct and portfolio investment. This contributed to a weaker NT dollar (NTD) in the second quarter. The second half will likely bring slower export expansion and reduce Taiwan's C/A surplus. END SUMMARY.

BOP Surplus Soaring

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[1](#)2. In the first half of 2004, Taiwan's BOP surplus totaled US\$24.15 billion, more than doubled the surplus for the same period of 2003. Depreciation of the Euro and the Japanese yen relative to the US\$ reduced the US\$ value of Euro- and Yen-denominated assets by US\$0.67 billion. Consequently, Taiwan's FOREX reserves after valuation change increased by US\$23.5 billion, from US\$211.1 billion in December 2003 to US\$234.6 billion in June 2004.

Banking Sector's Huge Borrowing from Abroad

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[1](#)3. According to Chen Yu-shiu, a section chief at the Central Bank of China's Economic Research Department, banks borrowing from abroad to fund foreign currency loans to local business firms was a major factor behind the sharp increase in Taiwan's BOP surplus. Foreign currency loans reached some US\$25 billion in the first half of 2004, about 2.3 times higher than the nearly US\$11 billion in the same period of 2003. These foreign currency loans were needed to purchase production inputs used to fill surging export orders. In the first six months of this year, Taiwan's imports have shot up by 35%. The borrowing contributed to the banking sector's increased foreign liability from US\$26.8 billion in December 2003 to US\$46.2 billion in June 2004, while the value of banks' foreign assets remained at US\$43.5 billion.

Capital Outflow Weakens NT Dollar

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[1](#)4. In response to Taiwan's opening of the stock and bond markets to foreign investors in October 2003, large sums of foreign capital flowed into the island in the third quarter of 2003. However, political events after Taiwan's March 2004 presidential election, and fluctuations in New York Stock Exchange share prices caused mutual fund managers to pull out money from Asian markets, including Taiwan. Foreign portfolio investors took US\$1.2 billion out of Taiwan in the second quarter of 2004, reversing an inflow of US\$7.3 billion in the first quarter, and reducing foreign portfolio investors' cumulative net capital inflow in the first half of 2004 to US\$6.2 billion, down from US\$7.4 billion a year ago.

[1](#)5. The capital outflow weakened the NTD and share prices on Taiwan's stock market. The stock market index plunged 25%

from 7,034 points in early March to 5,316 points in early August. The NTD depreciated 4.3% from NT\$32.798 per USD in April 2004 to NT\$34.199 per USD in late July 2004.

#### C/A Surplus Offset by Capital Outflow

16. Taiwan's current account (C/A) surplus of US\$11 billion in the first half of 2004 was almost matched by the net capital outflow of US\$10 billion in direct and portfolio investment. Outbound direct investment in the first half of 2004 surged 60% from a year ago to US\$3.5 billion, 4.6 times inbound direct investment of US\$0.7 billion. Outbound portfolio investment declined 33% to US\$13.5 billion, but was still more than twice the inbound portfolio investment.

#### Sharp Increase in Service Trade Deficit

17. Taiwan's service trade recorded a US\$2.1 billion deficit in the first half of 2004, 74% above a year ago. The increased deficit is partly mainly due to more Taiwan residents traveling abroad after the fear of SARS (the contagious disease) subsided in late 2003. Passengers departing Taiwan in the first half of 2004 totaled 3.7 million persons, up 66% from a year earlier and 2.7 times the number of inbound passengers. The "travel account" deficit in the first half of 2004 soared 83% from a year ago to US\$2.5 billion.

#### Export Expansion Prompts Imports to Grow Faster

18. Taiwan's C/A surplus in the first half of 2004 declined 23% from a year ago to US\$11 billion due to: 1) imports of production inputs, and 2) a sharp increase in overseas travel. Imports on fob basis totaled US\$74.5 billion, an increase of 35% while exports were US\$83.5 billion, 25.8% greater than a year ago. The overall BOP trade surplus fell by 19% from a year ago to US\$9 billion. The export growth increased demand for industrial materials and semi-finished goods.

#### Income from FOREX Reserves Declines

19. Interest from CBC FOREX reserves has historically kept Taiwan's "factor income" account in surplus. Taiwan's FOREX reserves are mainly deposited in U.S. and Japan banks, and foreign government bonds. However, a steady decline in interest rates in the United States prior to early July 2004 drove the CBC's interest earnings down by 8% to US\$5.2 billion. According to George Chou, Director General of the CBC's Foreign Exchange Department, the rate of return for Taiwan's FOREX reserves in the first half of 2004 averaged 3.5 - 4.5%, less than the average 5-6% in the past, but higher than bank interest.

#### Prospects

10. Tsai Hung-kun, Deputy Director of the DGBAS' Statistical Bureau, predicts Taiwan's C/A surplus will likely continue in the second half of 2004 but will decline due to slower export expansion. He expects export growth to slow to barely above 10% in the fourth quarter of this year and to 7% in 2005. He also foresees improved cross-strait relations resulting from the recently cancelled military maneuvers, and expects foreign portfolio investors to bring capital back to Taiwan. Unless fluctuations in foreign stock markets prompt a large redemption, this would extend the BOP surplus through the second half of 2004, and subject the NTD to heavy appreciation pressure.

Appended Table 1

Taiwan's Balance of Payments for 1st Half of 2003 & 2004  
(unit: million US\$)

Item	1st Half 2004	1st Half 2003
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A. Current Account (C/A)		
B. Merchandise Trade		
- Exports (fob basis)	83,529	66,413
- Imports (fob basis)	-74,496	-55,297
- Surplus	9,033	11,116
C. Service Trade		
- Credit	13,680	10,622
- Debit	-15,771	-11,825
- Deficit	-2,091	-1,203
D. Factor Income		
- Credit	7,322	6,943
- Debit	-1,564	-1,258
- Surplus	5,758	5,685
E. Unrequited Transfer		
- Credit	1,606	1,257
- Debit	-3,311	-2,496

- Deficit	-1,705	-1,239
<b>F. Current Account Surplus (B through E)</b>	<b>10,995</b>	<b>14,359</b>
<b>G. Capital Account (deficit)</b>	<b>-48</b>	<b>-39</b>
<b>H. Financial Account</b>		
<b>I. Direct Investment</b>		
- Outbound	-3,469	-2,172
- Inbound	747	559
- Deficit	-2,722	-1,613
<b>J. Portfolio Investment</b>		
- Outbound	-13,477	-20,031
- Equity Shares	-8,841	-12,117
- Bonds	-4,636	-7,914
- Inbound	6,162	7,382
- Equity Shares	4,406	6,168
- Bonds	1,756	1,214
- Deficit	-7,315	-12,649
<b>K. Other Investment</b>		
- Assets	3,633	6,003
- Liabilities	21,268	4,865
- Surplus	24,901	10,868
<b>L. Financial Account Balance (I through K)</b>	<b>14,864</b>	<b>-3,394</b>
<b>M. Net Errors &amp; Omissions</b>	<b>-1,664</b>	<b>796</b>
<b>N. Overall Balance (F+G+L+M)</b>	<b>24,147</b>	<b>11,722</b>
<b>O. Change in CBC's Net Assets</b>		
- Prior to Adjustment of		
- Valuation Change	-24,147	-11,722
<b>P. Valuation Change</b>	<b>670</b>	<b>-3,327</b>
<b>Q. Change in CBC's Net Assets</b>		
- after Adjustment of Valuation Change	-23,477	-15,049
- in Foreign Assets	654	-3,308
- in Gold	16	-19

Source: Central Bank of China

Appended Table 2  
Gold & Foreign Exchange Held by Taiwan  
As of June 2003 and June 2004  
(Million US\$)

Item	June 2004	June 2003
Central Bank of China:		
Gold	4,524	4,409
Foreign Exchange Reserves	230,092	176,686
International Reserves	234,616	181,095
Deposit Money Banks:		
Foreign Assets	43,485	43,176
Foreign Liabilities	46,161	26,800
Net Foreign Assets	231,940	197,471

Source: Central Bank of China

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